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Layman's guide to preparing financial statements for churches

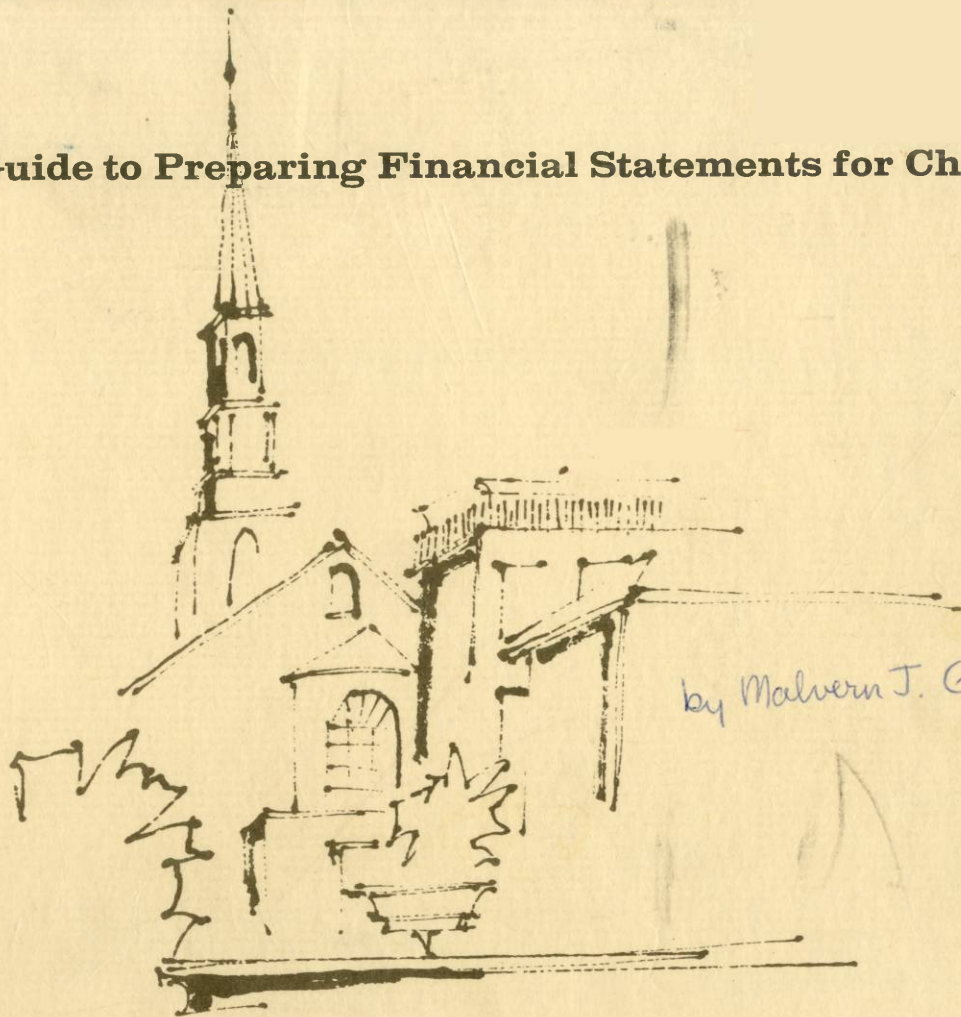
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The Layman's Guide to Preparing Financial Statements for Churches

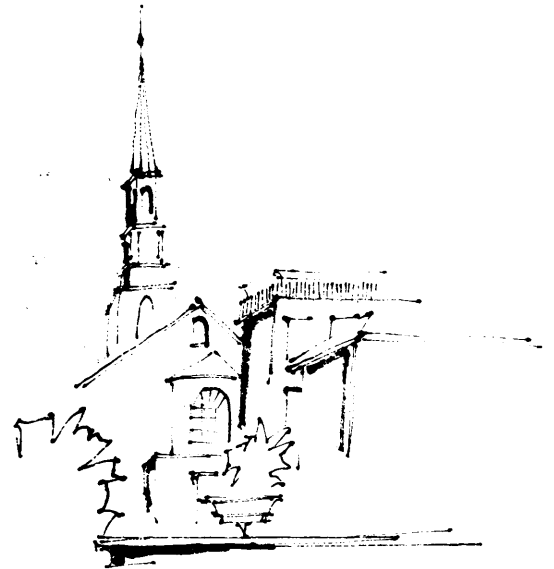


by Malvern J. Gross, Jr.

The layman's guide to
PREPARING FINANCIAL STATEMENTS FOR CHURCHES

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The layman's guide to

PREPARING FINANCIAL STATEMENTS FOR CHURCHES

One of the areas of financial reporting which has not received much attention in the past, and yet affects the pocketbooks of a substantial portion of our society, is the reporting by churches of their financial affairs to their members. While there have been a few articles written about bookkeeping procedures, internal controls, and business practices of churches, the subject and presentation of examples of meaningful financial statements for churches has been given scant attention. Very few church treasurers are accountants, and even of those who are, fewer still have had accounting experience with churches or nonprofit organizations.

So for the hard-pressed volunteer treasurer or financial officer of the church, this article proposes to offer some sensible formats for the usual church financial statements to the governing body and/or

to the members of the church and discuss some of the considerations and pitfalls in preparing these statements.

Characteristics of meaningful financial statements

Church financial statements to be meaningful should have the following characteristics:

1. They should be easily understood so that any member of the church who takes the time to study them will understand what they are saying. This characteristic is the one most frequently absent.
2. They should be concise so that the person studying them will not get lost in detail.

3. They should be all-inclusive and should embrace all activities of the church such as church schools, summer camps, etc. If there are two or three funds, the statements should clearly show the relationships between the funds without a lot of confusing detail involving transfers and appropriations.
4. They should have a focal point for comparison so the church member will have some basis of arriving at a conclusion. In most instances this will be a comparison with a budget or figures from the corresponding period last year.
5. They should be prepared on a timely basis. The longer the delay after the end of the period, the longer the period before corrective action can be taken.

You will note that the characteristics listed above would apply equally to almost any type of organization or business. Unfortunately, church financial statements frequently fail to meet these characteristics. There are a number of reasons for this. Probably the most important is that the treasurer or person responsible for the financial affairs is a volunteer doing the job on a part-time basis who does not have the time to develop a new set of statements.

It is easier to continue with what has been done in the past. Also there is a marked reluctance on the part of the nonaccountant to make changes in statement format because he lacks confidence in his abilities to tinker with the "mysteries" of accounting. Furthermore, just about the time that the treasurer is really becoming conversant with church statements and could start to make meaningful changes his term expires and he is replaced by someone else who has to start from scratch.

The use of budgets

Probably the most important tool in presenting more meaningful statements is the budget. Most churches prepare an annual budget which is the basis of fund raising and planning. However, all too often no attempt is made throughout the year to compare this budget with actual income and expense on a realistic basis and it is not until well after the entire year has passed that it is really apparent whether the budget objectives are going to be met or not. By that time, last year's budget becomes almost academic and no one pays any attention to it. What is needed is a budget that spotlights problem areas

during the course of the year.

Some churches attempt to do this by dividing the total budget by twelve and showing the resulting amounts as a monthly budget which is then compared to the income and expense monthly. While this is better than not making any budget comparison, it can produce misleading results where the income and expenses do not occur on a uniform basis throughout the year. Consider the following abbreviated statement:

	<u>Annual budget</u>	<u>Three months ending March 31</u>	
		<u>Budget</u>	<u>Actual</u>
		<i>(in thousands)</i>	
CONTRIBUTIONS	\$100	\$25	\$30
LESS EXPENSES	(100)	(25)	(20)
EXCESS	<u>-0-</u>	<u>-0-</u>	<u>\$10</u>

The logical conclusion that might be drawn is that the church will have a surplus at the end of 12 months of approximately \$40,000—4 times the quarterly excess of \$10,000. If this conclusion were reached the temptation would be to slacken off on

pledge collection efforts and to be a little less careful in making purchases. This would be a very serious mistake if, in fact, the normal pattern of pledge collections were such that \$35,000 should have been collected in the first quarter instead of the \$30,000 actually received, and compared to the \$25,000 budget prepared on a strictly pro rata basis. A budget can produce misleading conclusions unless considerable care is taken in preparing it.

Allocating an annual budget to monthly or quarterly periods

One of the best and easiest ways to allocate an annual budget into shorter periods is to analyze the actual income and expense for the last year on a period-to-period basis to see how the pattern of income and expense actually occurred. With this type of analysis it is possible to develop a budget for the coming year to reflect prior experience and adjust for known future events.

To illustrate, assume the church's income last year was \$100,000 but is expected to be \$120,000 this year. A budget for the new year could be prepared as follows:

	<u>Actual last year</u>	<u>Percent of last year's total</u> (in thousands)	<u>New budget</u>
INCOME			
First quarter	\$ 30	30%	\$ 36
Second quarter	25	25%	30
Third quarter	25	25%	30
Four quarter	20	20%	24
	<u>\$100</u>	<u>100%</u>	<u>\$120</u>

In this illustration we have assumed that the increase in income of \$20,000 will be received in the same pattern as the prior year's income was received. If this assumption is not correct, then adjustment must be made for the anticipated income which departs from past experience. For example, if it is anticipated that a single gift of \$10,000 will be received in the first quarter and the other \$10,000 will be received in about the same pattern as last year's income, our calculations to arrive at a new budget would be somewhat different, as shown above:

	<u>Actual last year</u>	<u>Percent of last year's total</u>	<u>New budget other than special</u>	<u>Special gifts</u>	<u>Total budget</u>
First quarter	\$ 30	30%	\$ 33	\$10	\$ 43
Second quarter	25	25%	27½	—	27½
Third quarter	25	25%	27½	—	27½
Fourth quarter	20	20%	22	—	22
	<u>\$100</u>	<u>100%</u>	<u>\$110</u>	<u>\$10</u>	<u>\$120</u>

If at the end of the first quarter income of only \$38,000 has been received compared to a budget of \$43,000, it would be apparent that steps should be taken to collect delinquent pledges or the church will fall short of meeting its budget for the year.

The expense side of the budget should be handled in the same way. Generally, expenses tend to be more uniform although this is not always so, particularly where there is a church school, summer camp or similar seasonal activity. In many ways the expense side of the budget is more important than

the income side since it is easier to increase expenditures for things that weren't budgeted than to raise additional contributions. A carefully thought-out expense budget which is regularly compared to actual expenditures for deviations is an effective tool to limit nonbudgeted expenditures.

The budget should probably be prepared on a monthly rather than on a quarterly basis so as to reduce the time lag before effective action can be taken. If monthly appears to be too cumbersome, consideration could be given to bimonthly budgets and statements. However, if the church's cash position is tight, monthly statements become almost a necessity.

Adjusting cash basis statements for unpaid bills

Most churches keep their financial records on a cash basis and do not attempt to maintain an accrual basis of accounting. This is usually appropriate because it often means that a church secretary or other nonbookkeeper can keep simple cash records for the church. However, if cash basis statements are to have any real meaning it will be necessary to reflect

any significant unpaid bills in these statements.

The bookkeeper should keep a folder of unpaid bills which should be reviewed at the time financial statements are prepared. If a bill has not been received, a best estimate should be used. The easiest way to handle these unpaid bills is on a work sheet, perhaps something along the following lines:

	<i>Per cash records</i>	<i>Unpaid bills</i>	<i>Total for statements</i>
PRINTING	\$1,156	\$161	\$1,317
PAYROLL	2,359	—	2,359

Of course, every nickel and dime item should not be accrued. Payroll sometimes can present a problem if the payroll for the current month is paid after the end of the month. This is particularly so if the payroll is for a portion of two months as it would be if the payroll were paid every two weeks. It is time consuming to calculate the amount applicable to each period. This can be overcome by adopting a monthly or semimonthly pay period, or if that is not practicable, by taking actual pay dates into consideration in preparing the original monthly or quarterly budgets.

FIGURE 1**MEDIUM-SIZE CHURCH****FINANCIAL REPORT SHOWING BUDGET COMPARISON***Summary of income and expenses and comparison with budget***FOR THE THREE MONTHS ENDED MARCH 31, 1966**

	<u>Actual</u>	<u>Budget</u>	<u>Actual over (under) budget</u>
INCOME:			
Plate collections	\$ 2,450	\$ 2,600	(\$150)
Envelopes and pledges	18,116	20,100	(1,984)
Special gifts	1,450	1,000	450
Investment income	1,385	1,000	385
	<u>23,401</u>	<u>24,700</u>	<u>(1,299)</u>
EXPENSES:			
Clergy	7,325	7,500	(175)
Music	4,285	4,200	85
Education	3,010	3,200	(190)
Church office	3,302	3,100	202
Building maintenance	1,915	2,200	(285)
Missions	1,000	1,000	—
Other	2,316	800	1,516
	<u>23,153</u>	<u>22,000</u>	<u>1,153</u>
EXCESS OF INCOME OVER EXPENSE	\$ 248	\$ 2,700	(\$2,452)

Format of financial statements

Illustrated in Figure I is a format of a monthly financial statement of a medium-size church.

A member of the church who studies this statement might react as follows:

1. While special gifts and investment income is up, envelopes and pledges are down with the result that the total budgeted income has not been received.
2. The church has overspent its budget in "church office" "music" and "other" expenses.
3. While the church had a slight excess of income over expense during this three-month period, the excess was less than budgeted.

Frequently the treasurer will attach a brief narrative explanation to the statements explaining the reasons for the significant deviations.

We have discussed the income and expense statement but have made no mention of a balance sheet. Generally, there is little need for preparing a balance sheet each month showing assets and liabilities unless the cash position is very tight. Many account-

ants may feel ill at ease in not having a balance sheet as part of the monthly statements, but it should be kept in mind that the preparation of a balance sheet is time consuming and can be complicated in the case of cash basis accounting with unpaid bills. Since the balance sheet doesn't normally add information that will result in action being taken, it should be prepared only on a semiannual or annual basis.

Multiple fund statements

Very often a church has more than one fund. Typically, there is a general fund, a building fund, an endowment fund and other special purpose funds which are restricted in some manner. Normally the day-to-day activities of the church are handled through the general fund and these other funds are used only for the restricted purpose indicated. Management problems of control over these restricted funds are fewer because of the nature of the restrictions and because the volume of activity is usually less. Accordingly, many churches do not try to show these other funds in their monthly financial statements but limit their monthly statements to the activity in the general fund. On a semiannual or

FIGURE 2

MEDIUM-SIZE CHURCH FINANCIAL REPORT SHOWING SEVERAL FUNDS

Income and expense for all funds

FOR THE SIX MONTHS ENDING JUNE 30, 1966

	<u>General fund</u>		<u>Building fund</u>	<u>Endowment fund</u>	<u>Funds for specified purposes</u>	<u>Total all funds</u>
	<u>Actual</u>	<u>Budget</u>				
INCOME:						
Plate collections	\$ 4,851	\$ 5,000				\$ 4,851
Envelopes and pledges	36,316	38,200	\$3,211			39,527
Special gifts	2,253	2,000	75	\$250	\$2,316	4,894
Investment income from endowment funds	2,785	2,000				2,785
Interest	—	—	40			40
	<u>46,205</u>	<u>47,200</u>	<u>3,326</u>	<u>250</u>	<u>2,316</u>	<u>52,097</u>
EXPENSES:						
Clergy	14,325	15,000				14,325
Music	8,610	8,400				8,610
Education	6,850	7,000				6,850
Church office	5,890	6,200				5,890
Building maintenance	4,205	4,300				4,205
Missions	2,000	2,000				2,000
Mortgage payments	—	—	3,126			3,126
Other	3,318	1,600			1,976	5,294
	<u>45,198</u>	<u>44,500</u>	<u>3,126</u>	<u>-0-</u>	<u>1,976</u>	<u>50,300</u>
EXCESS OF INCOME OVER EXPENSE FOR THE PERIOD	\$ 1,007	\$ 2,700	\$ 200	\$250	\$ 340	\$ 1,797

FIGURE 3**MEDIUM-SIZE CHURCH****SUPPLEMENTARY SCHEDULE SHOWING DETAILS OF INDIVIDUAL FUNDS***Statement of changes in funds for specified purposes*

FOR THE SIX MONTHS ENDING JUNE 30, 1966

<u>Fund</u>	<u>Balance January 1, 1966</u>	<u>Contributions</u>	<u>Less expenditures for designated purpose</u>	<u>Balance June 30, 1966</u>
Chapel flowers	\$ 34	86	(\$79)	\$ 41
Scholarships	221	1,650	(1,500)	371
Fresh Air Camp Fund	100	330	(174)	256
Hymn books (M. Smith Memorial)	169	—	(126)	43
Rector's discretionary fund	116	250	(97)	269
	<hr/>	<hr/>	<hr/>	<hr/>
	\$640	\$2,316	(\$1,976)	\$980
	<hr/>	<hr/>	<hr/>	<hr/>

quarterly basis a combined statement is appropriate. Illustrated in Figure 2 is a statement showing how the activity of all funds of a church can be shown on a single statement.

One of the real advantages of showing these funds in this format is that it makes it possible for the reader to see all of the activities of the church in one statement. If a separate statement were prepared for each of the funds, the reader often gets confused as to what really took place and by the time he finishes reviewing the statements he is both confused and frustrated.

You will note in Figure 2 that the \$2,785 of investment income which the endowment fund earned was recorded directly in the general fund. It could have been shown in the endowment fund column and later transferred to the general fund. However, since transfers back and forth cause confusion, it has been shown directly in the general fund.

In this illustration we have shown a budget comparison for only the general fund. Instead, we could have shown a budget comparison in total for all funds. The preparer of the statements should show the budget comparison in the most meaningful manner. In this instance the budget comparison was limited to the general fund since this was the fund

that needed close watching for deviations. This is a matter of preference and judgment.

The funds for specified purposes are usually composed of a lot of small amounts and do not warrant detailed disclosure except perhaps on an annual basis. If it appears desirable, the detail of these funds can be shown as a supplementary schedule in the format shown in Figure 3.

A word of caution—There is a tendency to present far more detail than is necessary or appropriate, particularly in the annual report. Too much detail tends to defeat the purpose of the statement in that the reader may lose track of the overall picture of the church. The statement should tell the reader what happened without burdening him with unnecessary information. If someone wants further detail, let him request it and then provide it on an individual basis.

You will note in Figure 3 that we have shown the opening and closing balance of each of the funds along with the activity during the period. This same type of presentation is also appropriate for the other funds. For example, refer to Figure 2. Instead of ending at the line “excess of income over expense for the period” we could have continued in the following manner:

	<i>General fund</i>		<i>Building fund</i>	<i>Endowment fund</i>	<i>Funds for specified purposes</i>	<i>Total all funds</i>
	<i>Actual</i>	<i>Budget</i>				
Excess of income over expenses for the period . . .	\$1,007	<u>\$2,700</u>	\$200	\$ 250	\$340	\$ 1,797
Add fund balance January 1, 1966	<u>5,752</u>		<u>145</u>	<u>85,161</u>	<u>640</u>	<u>91,698</u>
Fund balance June 30, 1966	<u>\$6,759</u>		<u>\$345</u>	<u>\$85,411</u>	<u>\$980</u>	<u>\$93,495</u>

Balance sheet

If there had been a transfer of part of the fund balance between funds, it would probably be shown in the above illustration on the line immediately following "excess of income over expense." However, since transfers back and forth between funds tend to confuse most nonaccountants these transfers should be avoided except on a very occasional basis and then only with the approval of the governing body of the church.

For many small churches the only asset of significance to the member is the cash balance, even though there might be substantial value in the church buildings.

If this is the case and if all major bills have been paid for by the end of each period, then the balance sheet can be prepared quite simply by adding a few lines to the bottom of the income statement, as follows:

Fund balance end of period	\$6,759
Balance composed of:	
Cash in saving account	\$5,000
Cash in checking account	1,709
Petty cash	50
	<u>\$6,759</u>

In a larger church and particularly one having investments and other assets this simplified presentation would not be appropriate. Shown in Figure 4 is a balance sheet having assets other than cash, and having several separate funds.

You will note in Figure 4 that one of the advantages the reader has with this type of statement is that he can see the total position of all funds quite clearly as well as the position of the individual funds. The total of the fund balances should agree, of course, with the balances shown on the income and expense statement on the bottom line.

Fixed assets and mortgage payments

Many churches do not attempt to record their principal asset—the church building and property—in their books. A major reason is that the historical

cost or even replacement value has no significance as far as the financial statements are concerned. In all likelihood the property will never be sold and it has value only to the members of the church in its present form.

Another significant factor is that financial statement presentation problems become complicated and confusing to the unsophisticated reader. For example, in a church with mortgage payments, a building fund may be used to record contributions which are used for mortgage payments. On a cash basis, the total mortgage payment is shown as a disbursement. However, if the cost of the property and the bank loan were recorded as an asset and liability at the time the building was purchased, then the income and expense statement can only show the interest portion of the mortgage payment as an expense. For example, assume the church property cost \$1,000, and the bank mortgage at the beginning of the year was \$500. The cash basis approach would look quite different from the accrual basis in the financial statements (see next page).

On a day-to-day basis, the cash basis presentation is usually more useful and easier to understand by the average reader. In this case it tells him that his cash contributions were enough to cover the mortgage payment and that there is \$30 in the bank as a reserve.

FIGURE 4**MEDIUM-SIZE CHURCH**

STATEMENT OF ASSETS AND LIABILITIES OTHER THAN CHURCH PROPERTY

JUNE 30, 1966

<u>Assets</u>	<u>General fund</u>	<u>Building fund</u>	<u>Endowment fund</u>	<u>Funds for specified purposes</u>	<u>Total all funds</u>
Cash	\$6,668	\$345	\$ 1,201	\$980	\$ 9,194
Marketable securities at cost (approximate market value \$106,000)			84,210		84,210
Accounts receivable	981				981
Other	321				321
Total assets	7,970	345	85,411	980	94,706
Less Accounts payable	(1,211)				(1,211)
Fund balance	\$6,759	\$345	\$85,411	\$980	\$93,495

INCOME STATEMENT	<u>Cash basis</u>		<u>Accrual basis</u>	
Contributions	\$100		\$100	
Less mortgage payment (of which \$40 is interest) ..	<u>(90)</u>		<u>(40)</u>	(Interest only)
Excess of income over expense	<u>\$ 10</u>		<u>\$ 60</u>	
	<u>Cash basis</u>		<u>Accrual basis</u>	
	<u>1/1</u>	<u>12/31</u>	<u>1/1</u>	<u>12/31</u>
BALANCE SHEET				
Cash	\$20	\$30	\$ 20	\$ 30
Church property	<u>-0-</u>	<u>-0-</u>	1,000	1,000
Fund balance (cash basis)	<u>\$20</u>	<u>\$30</u>		
Less bank mortgage			<u>(500)</u>	<u>(450)</u>
Fund balance			<u>\$ 520</u>	<u>\$ 580</u>

Summary

This article has discussed some of the major characteristics of meaningful financial statements and pointed out that a carefully prepared budget comparison in financial statements and the proper presentation of multiple fund financial statements in a single statement are major aids to the church member in arriving at meaningful conclusions. We have

shown examples of sound financial reports and it is hoped that these may guide the volunteer church financial officer to presentations that are easier to compile and understand. The nonaccountant should not hesitate to use his own common sense in preparing meaningful statements tailored to fit the needs of his own church.